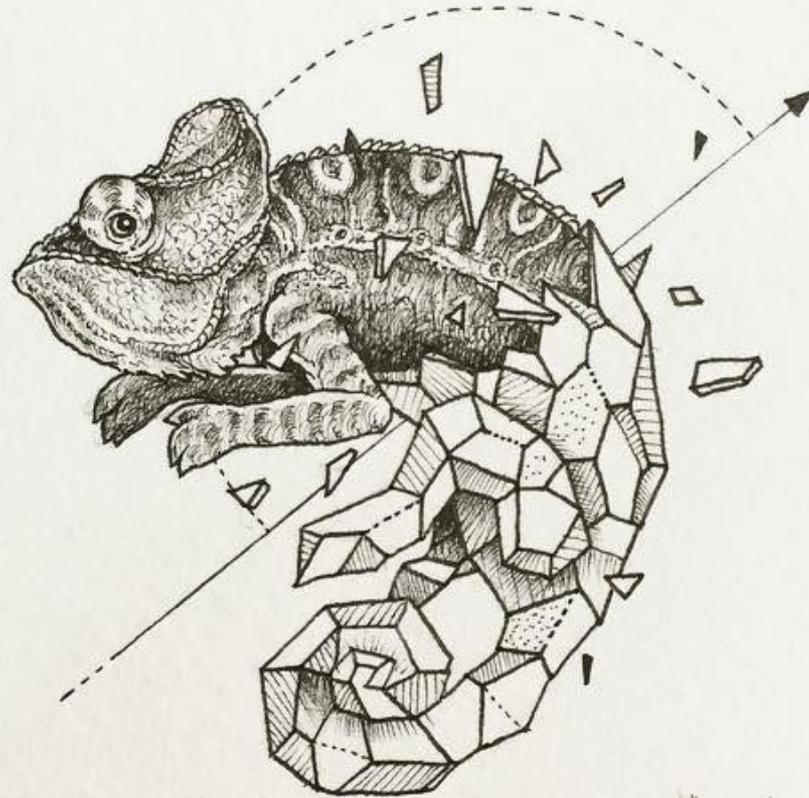


INCOME TAX: SECTION 7C



PRESENTER:

Gert van den Berg

Delport van den Berg

Estate & Trust Services (Pty) Ltd

1. Section 7C of the Income Tax Act
2. Debt Reduction for Less Than Full Consideration



INTEREST FREE AND LOW INTEREST LOANS TO TRUSTS AND CERTAIN COMPANIES BY CONNECTED PERSONS

- The provisions of this section apply to any **loan, advance or credit directly or indirectly** provided:

BY

- a **natural person** or
- **at the instance of a natural person** by any **company**, in relation to which that natural person is a **connected person**, in terms of **paragraph (d)(iv)** of the definition of connected person,

TO

- a **trust in relation to which** -
 - **That person or company**; or
 - Any person that is a connected person in relation to the person or company referred to above

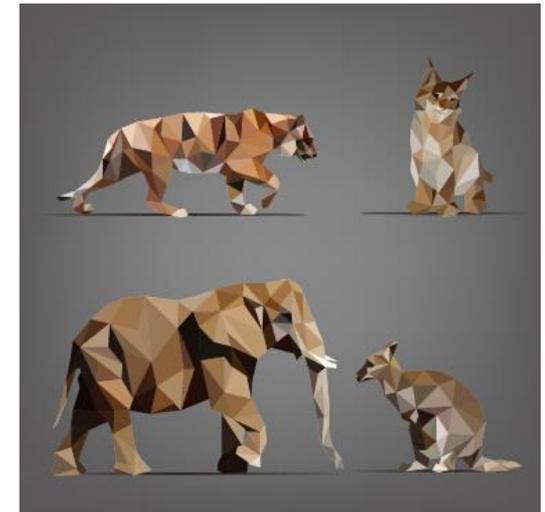
IS A CONNECTED PERSON

OR

TO

- a **company** if at least **20%** of
 - the **equity shares** in the company are held [directly or indirectly] by **or**
 - the **voting rights** in that company can be exercised by **the trust** referred to above, whether alone or **together with** any person who is a **beneficiary** of that trust or the **spouse** of a beneficiary of that trust or **any person related to that beneficiary or that spouse within the second degree of consanguinity.**

The difference between the interest charged and the official tax rate (repo rate plus 1%) on such loan is **deemed to be an ongoing and annual donation** made by the natural person to the trust on the last day of the year of assessment of the trust.



SECTION 7C (1A)

To counter certain further avoidance schemes a new subsection (1A) was introduced stating that:

*(1A) If a natural person **acquires a claim** to an amount owing by a trust or a company in respect of a loan, advance or credit referred to in **subsection (1)**, that person must for purposes of this section be treated as having **provided the loan**, advance or credit to that trust or company-*

*On the date on which the person **acquired that claim**; or*



SECTION 7C (1A)

If that person was **not** a connected person on that date in relation to-

- that trust; or
- the person who provided that loan, advance or credit to that trust or company,

on the date on which that person **became a connected person** in relation to that trust or person,

that is equal to the amount of the claim so acquired.



SECTION 7D

A new **Section 7D** was introduced, providing that:

...the amount incurred as interest in respect of any loan, debt or advance or amount of credit provided to a person or an amount owed by that person had that interest been incurred at the official rate of interest must be determined without regard to any rule of the common law, in terms of which-

- (a) the amount of interest, fee or similar finance charge that accrues or is incurred in respect of a debt may not in aggregate exceed the amount of that debt or;*
- (b) no interest may accrue or be incurred in respect of a debt once the amount that has accrued or been incurred as interest is equal to the amount of that debt.*

These measures are aimed at nullifying the effect of the *in duplum* rule in common law which basically states that the amount of interest recoverable from a debtor could never exceed the capital amount of the debt.

Section 7C - Exemptions:

The provisions do not apply if:

- (a) The trust or company **owing** the loan is a **Public Benefit Organisation** approved by the Commissioner in terms of section 30(3) of the Act or a **Small Business Funding Entity** approved by the Commissioner in terms of Section 30C;

or

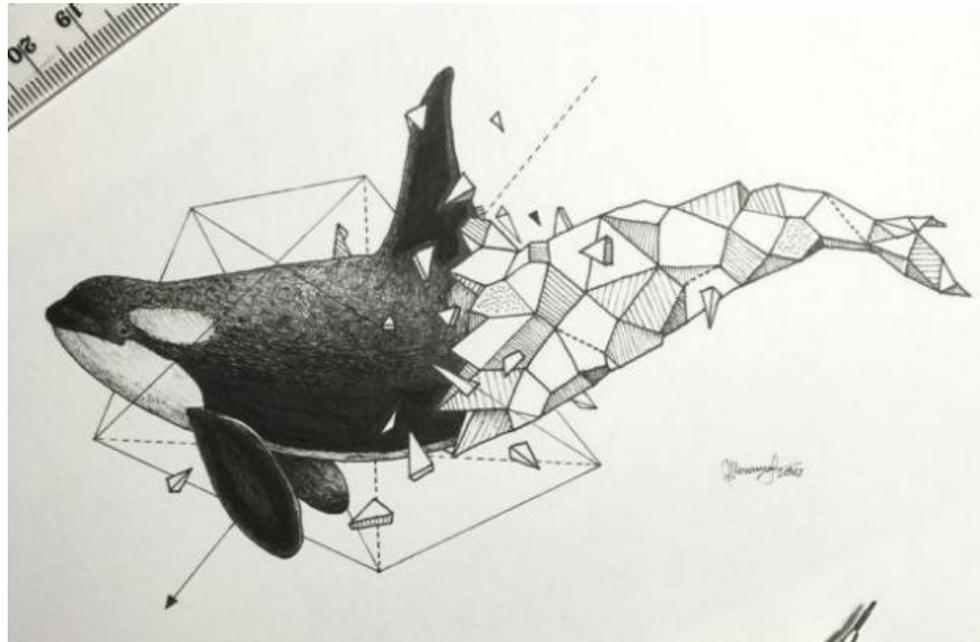
- (b) The loan, advance or credit was provided to the trust by a person by reason of or in return for a vested interest held by that person in receipts and accruals and assets of that trust and;
- The beneficiaries of the trust hold in aggregate **a vested interest** in all the receipts, accruals and assets of the trust;
 - No beneficiary can in terms of the trust deed hold or acquire an interest in the trust **other than a vested interest** in the receipts, accruals and assets of the trust.

Section 7C - Exemptions:

- The vested interest of the beneficiary is determined solely with reference and in proportion to the assets, services or funding contributed by that beneficiary to the trust and;
- **None** of the vested interests held by the beneficiaries of that trust is **subject to a discretionary power** conferred on any person in terms of which that interest can be varied or revoked.
- **NOTE:** It is important to note that not all trusts, where beneficiaries have vested rights, will qualify for this exemption - only trusts where the beneficiary's interest is determined by his contribution to the trust.

Section 7C - Exemptions:

- **However**, on page 13 of the Declaratory Memorandum it is stated that “loan by a trust beneficiary to a trust that qualifies as a *bewind* trust, i.e. a trust that holds and administers assets, the ownership of which vests in that beneficiary, for/on behalf of that beneficiary” will also qualify for the exemption in terms of the subsection mentioned above.



Section 7C - Exemptions:

or

- (c) The trust is a **special trust as defined in paragraph (a)** of the definition of a special trust (i.e. a trust solely for the benefit of one or more persons who are persons with a disability, as defined, where such disability incapacitates such person or persons from earning sufficient income for their maintenance, or from managing their own financial affairs);

or

- (d) The trust or company used the loan **wholly or partly** for purposes of funding the acquisition of an asset, which asset was used, **throughout the year of assessment**, by the **person granting the loan or the spouse of that person**, as a **primary residence** (as defined in the Income Tax Act) and the amount owed relates to the part of the loan, advance or credit that funded the acquisition of that asset;

Section 7C - Exemptions:

or

- (e) The loan, advance or credit constitutes an **affected transaction as defined in section 31(1)** that is subject to the provisions of that section (transfer pricing provisions);

or

- (f) The loan, advance or credit was provided to the trust or the company in terms of an arrangement that would have qualified as a **Sharia compliant financing arrangement as contemplated in section 24JA, had the trust been a bank as defined in that section;**

or

- (g) The loan, advance or credit is subject to the provisions of **section 64E(4)** (i.e. where the loan was made to the trust by a company and is deemed to be a dividend by that company to the trust in terms of the said section).

Section 7C - Exemptions:

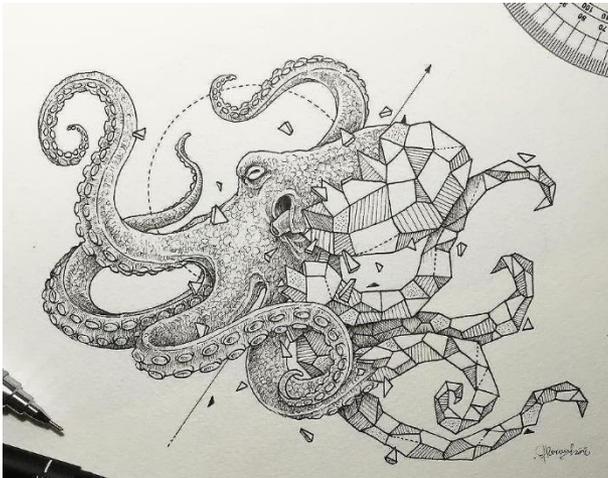
or

(h) That trust was created solely for purposes of giving effect to an **employee share incentive scheme** in terms of which -

(i) that loan, advance or credit was provided -

(aa) by a company to that trust; or

(bb) for purposes of funding the acquisition, by that trust, of shares in that company or in any other company forming part of the same group of companies as that company (hereinafter referred to as a 'scheme company');



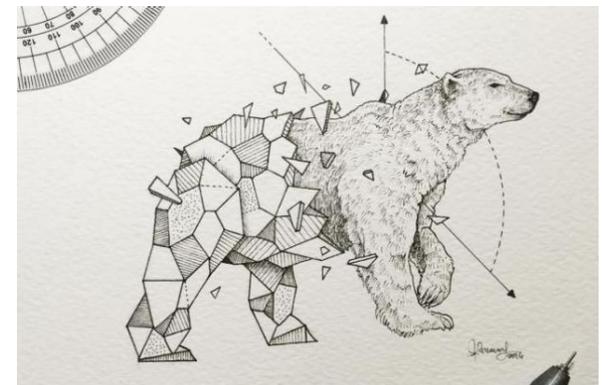
Section 7C - Exemptions:

- (ii) equity instruments, as defined in section 8C, that relate to or derive their value from shares in a **scheme company** may be offered by that trust to a person solely by virtue of that person—
 - (aa) being in employment on a **full-time basis** with; or
 - (bb) holding the **office of director** of,
a **scheme company**; and
- (iii) a person that is a **connected person** in terms of paragraph (d)(iv) of the definition of connected person in relation to any scheme company is not entitled to participate in that scheme.

Section 7C - Result where abovementioned provisions apply:

— Donation:

- An amount equal to the difference between the amount incurred by the trust in respect of the year of assessment and the amount that would have been incurred by the trust at the **official rate of interest** will be treated as a donation made to the trust, on the last day of the year of assessment, by the person who made the loan to the trust;
- The amount of the donation is determined as a **simple interest** at the **official rate** calculated on a **daily basis** and **reduced** by actual interest paid.
- **Donations Tax payable on last business day of March.**



Section 7C - Result where abovementioned provisions apply:

- **Deduction, loss, allowance or capital loss:**
No deduction, loss, allowance or capital loss may be claimed in respect of:
 - a disposal, including by way of reduction or waiver or;
 - the failure wholly or partly of a claim of the payment;of any amount owing in respect of a loan, advance or credit referred to above.
- **Loan made at the instance of more than one person:**
Where the loan, advance or credit was provided by a company to a trust at the instance of more than one person, that is a connected person in relation to the company, each of those persons will be treated as having donated to the trust the part of that amount that bears to that amount the same ratio as the equity shares or voting rights in that company that were held by that person during the year of assessment bears to the equity share or voting rights in that company held in aggregate by those persons during that year of assessment.

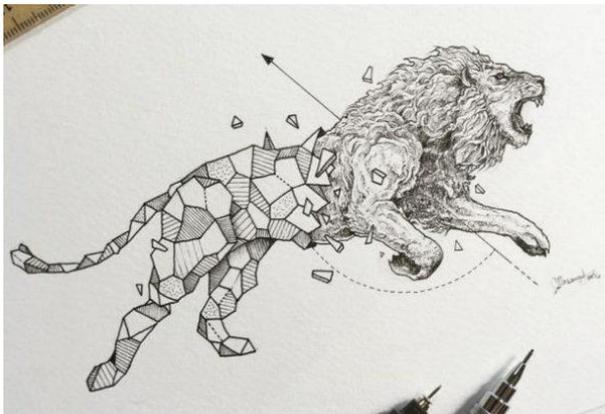
Section 7C - Result where abovementioned provisions apply:

Example:

Mr X made a loan to his trust amounting to R 10 000 000.00 which was utilised by the trust to buy shares. He charges interest at 5%. The official rate, as defined, is 7.5%.

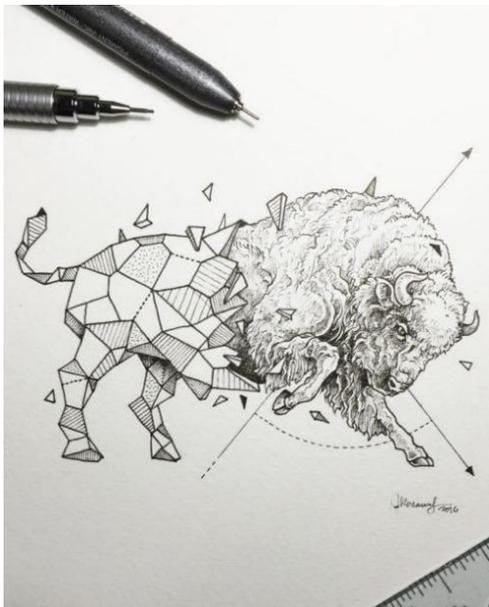
Donation: R 10 000 000 x (7.5%-5%)= R 250 000
Donations Tax:

Deemed Donation	R 250 000
Less Annual Exemption	<u>R 100 000</u>
	<u>R 150 000</u>
Donations Tax @ 20%	R 30 000



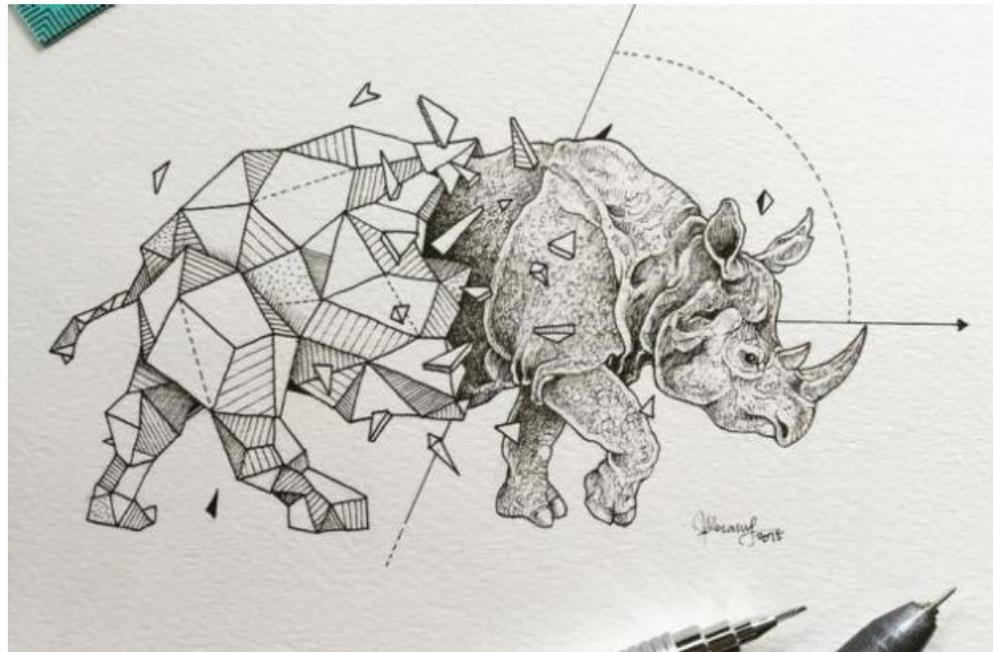
Section 7C - Summary

The provisions should not apply in the case where the trust deed provides that the trustees can, **in their sole discretion**, decide to **credit distributions on loan account on behalf of a beneficiary**, payment of which will be in discretion of the trustees, in which case the **ensuing loan account does not constitute a loan** as envisaged as there is **no contract of loan between the beneficiary and the trustee**.



Section 7C - Summary

On page 11 of the Declaratory Memorandum it is clearly stated that any distribution to a beneficiary, which is **vested irrevocably by the trustees** in the beneficiary and **used or administered** for the benefit of the beneficiary **without distributing or paying** the amount to the beneficiary, will **not** qualify as a loan or credit provided **by that beneficiary** to the trust **provided** that:



Section 7C - Summary

- either the trust deed **contains provisions** preventing the trustees from distributing that amount to the beneficiary (e.g. where a beneficiary only becomes entitled to a distribution at a certain age); **or**
- **the trustees have sole** discretion in terms of the trust deed to decide on the **timing and extent** of any distribution of such vested amount to the beneficiary.



Section 7C - Summary

It is also clearly stated that, should the **beneficiary have any say** in whether or when the amount so vested should be distributed **or enters into agreement** with the trustees in terms of which the amount may be retained in trust, such amount will be treated as a loan or credit to the trust by that beneficiary as envisaged in Section 7C.



SECTION 7C - LOAN TO A COMPANY OF WHICH THE SHARES ARE HELD IN TRUST

- The same **exemptions** will apply, *mutatis mutandis* to a loan made to a company as envisaged, excluding exemptions specifically applicable to trusts.



COMMENCEMENT DATES:

- Section 7C was introduced in 2016 - **effective from 1 March 2017** - Applicable to any affected loan provided to the trust **on or after that date**.
- The extended Section 7C was introduced in 2017 and revised in 2018 - **effective from 19 July 2017**.

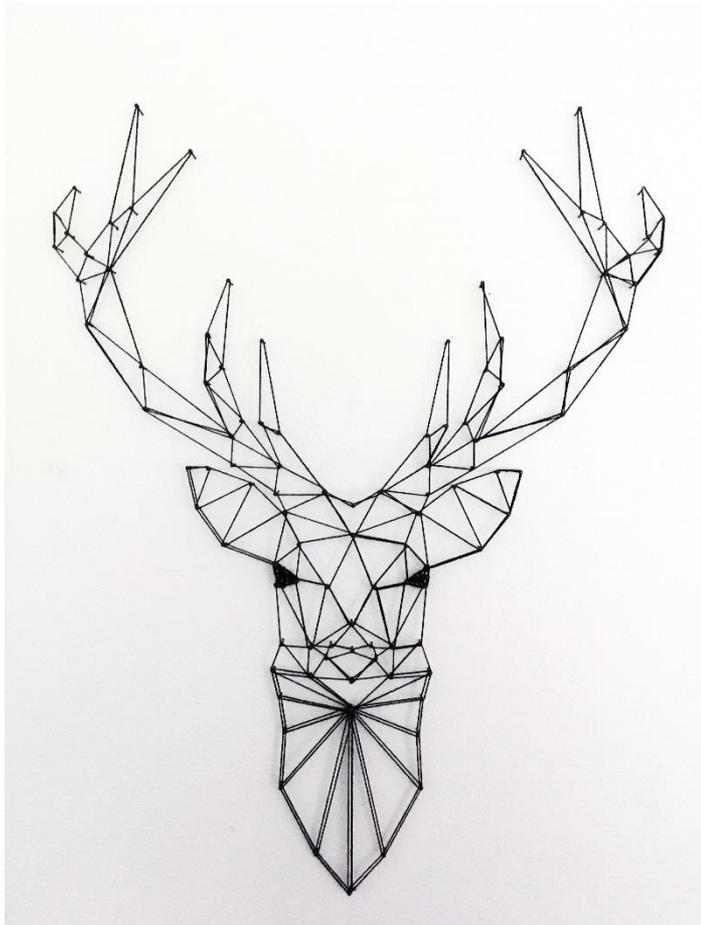
Solutions:

- Every case to be considered on merit;
- Where the loan is R 1 333 335.00 or less and no interest is charged - no donations tax.
- Consider using spouse while still possible.
- Where loan is substantial, consider the following:
 - Pay as much interest as the trust can deduct for tax purposes;
 - Depending on circumstances - might be better to donate loan account or part thereof than to transfer assets out of trust;
 - Consider financing to repay loan.

Consider the following:

- Interest free loan to trust : R 10 000 000
(Trust has no income)
- Interest @ 7.5% : R 750 000
- Donations Tax
- $(750\,000 - 100\,000) \times 20\%$ R 130 000 p.a.
- After almost 14 years the Donations Tax paid annually will exceed the donations tax that would have been payable if the loan was donated in full

THE FUTURE OF TRUSTS IN THE LIGHT OF SECTION 7C



While the provisions of **Section 7C** complicates the use of Trusts in Estate Planning, careful planning by specialist advisors can still result in the trust being a viable estate planning tool, depending on the circumstances of each case.

DECEASED ESTATES:

Say natural person who made the loan dies on 1 August 2018:

- Interest till 1 August 2018 will be deemed a donation on 28 February 2019.
 - Estate will most probably pay Donation Tax and should be able to deduct amount paid for Estate Duty purposes.

Problem areas:

- Deceased estate (executor) not a connected person in relation to a trust
 - **INTERPRETATION NOTE 67**;
- **Section 9HA** - where assets transferred directly to the heir - recipient is treated as having acquired the asset on date of death at market value.
- Accrual System.

DEBT REDUCTIONS FOR LESS THAN FULL CONSIDERATION:

(SECTION 19 OF THE INCOME TAX ACT AS WELL AS PARAGRAPH 12(A) OF THE 8TH SCHEDULE TO THE INCOME TAX ACT WAS AMENDED WITH EFFECT FROM 1ST OF JANUARY 2018 APPLICABLE IN YEARS OF ASSESSMENT STARTING ON OR AFTER THAT DATE:

It applies to, amongst others, the cancellation or waiver of a debt or the direct or indirect settlement of a debt through the conversion to or exchange for shares in the debtor company or the direct or indirect settlement of debt by applying the proceeds from shares issued by the debtor company.

DEBT REDUCTIONS FOR LESS THAN FULL CONSIDERATION *(CONTINUED)*:

Though some of these provisions are also applicable to debt incurred in the acquisition of **allowance assets** and **trading stock**, we will, for purposes of this discussion, only deal with debt incurred in the acquisition of capital assets and the provisions of the revised **Paragraph 12(A)(6)** of the 8th Schedule to the Income Tax Act and then only with Paragraphs **(a)** and **(b)** thereof.

DEBT REDUCTIONS FOR LESS THAN FULL CONSIDERATION *(CONTINUED)*:

In terms of Paragraph (a) the provisions will not apply to a debt owned by a person who is **an heir or legatee** in a **deceased estate** to the extent that:

- The **debt is owed to that deceased estate**;
- The debt is **reduced by the deceased estate**;
- The amount by which the debt is reduced by the deceased estate **forms property of the deceased estate for the purposes of the Estate Duty Act.**



DEBT REDUCTIONS FOR LESS THAN FULL CONSIDERATION *(CONTINUED)*:

- Note that the debt need not be **subject to Estate Duty** with the result that the exemption will still apply **even if there is no Estate Duty payable in the estate.**

-
- In terms of Paragraph (b) the provisions will not apply to the extent that the debt is reduced by way of donation as defined in Section 55(1); or
 - Any transaction to which Section 58 applies

in respect of which donations tax is payable (effective as from 1st of January 2019 and years of assessment starting on or after that date).

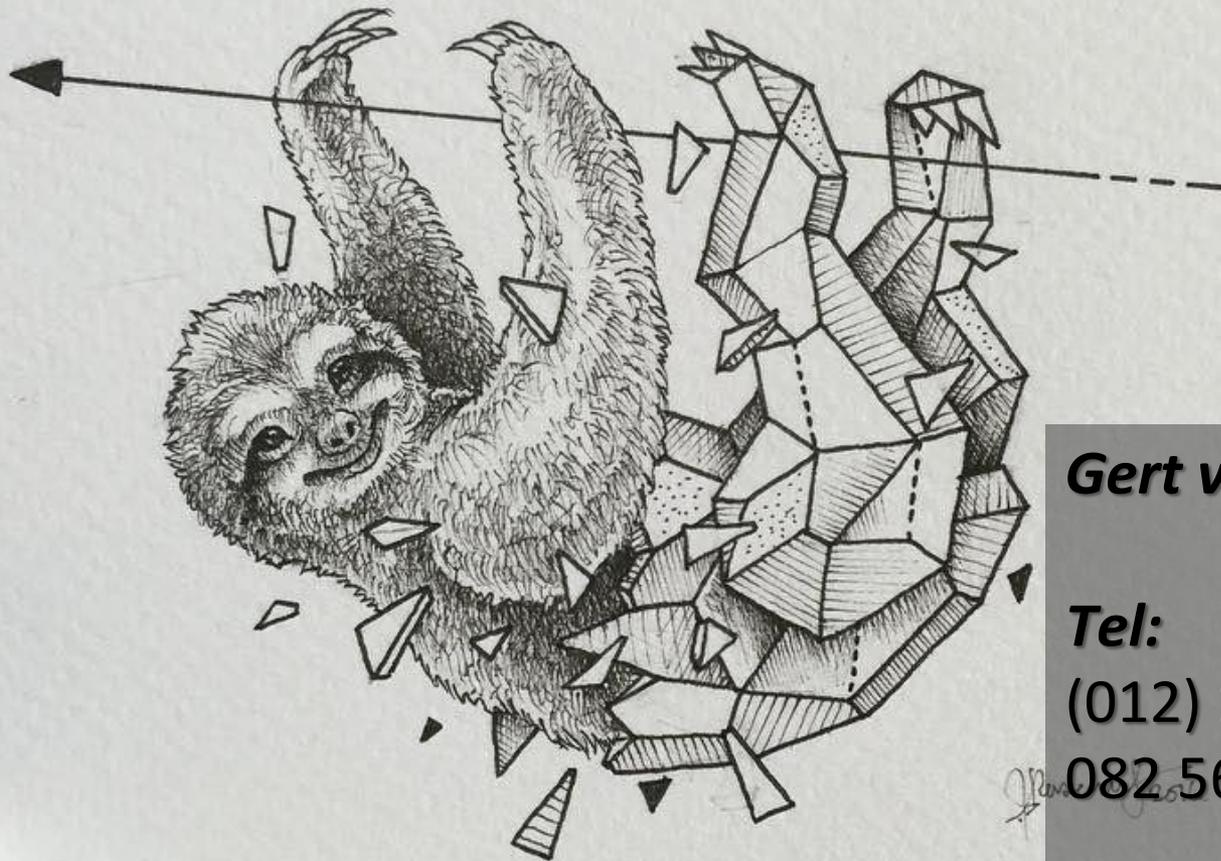
DEBT REDUCTIONS FOR LESS THAN FULL CONSIDERATION (*CONTINUED*):

Effect of the provision that the exemption in sub paragraph (b) only applies to donations **in respect of which** Donations Tax is payable.

Any donation made by a person who has not utilised the R100,000.00 annual exemption will result in the base cost of the asset bought with the loan being reduced by R100,000.00 (**being the part of the donation not subject to donations tax**).

A loan from a non resident to a resident trust, company or individual will not be subject to donations tax with the result that the full value of the loan on reduction will be subject to Capital Gains Tax.

Be careful of reducing loan accounts **owing by a beneficiary to a trust by way of a distribution *in specie*** of such loan account to the beneficiary.



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